Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of:	)	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers;	)	CC Docket No. 00-256
Federal-State Joint Board on Universal Service;	)	CC Docket No. 96-45
Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation;	)	CC Docket No. 98-77
Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers	)	CC Docket No. 98-166

REPLY COMMENTS OF INNOVATIVE TELEPHONE

Innovative Telephone ("Innovative") (formerly known as the Virgin Islands Telephone Corporation),[1] by its attorneys, hereby submits these reply comments in response to the *Further Notice of Proposed Rulemaking* in the above captioned proceeding.[2] An overwhelming majority of commenters agreed with Innovative that the Commission should continue to approach universal service and access charge reform carefully and in a manner that ensures rate-of-return

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1 The Virgin Islands Telephone Corporation is doing business under the trade name "Innovative Telephone."

2 *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, Second Report and Order and Further Notice of Proposed Rulemaking, FCC 01-304 (rel. November 8, 2001) ("*MAG Further Notice*").

carriers are able to maintain quality service and affordable rates.[3] The record also reflects substantial agreement with Innovative's position that the Long Term Support ("LTS") mechanism comprises a critical part of the total universal service support received by many rate-of-return carriers and that any decline in LTS support would undermine carriers' ability to maintain affordable rates.[4]

In their comments, several long-distance companies advocate imposing a mandatory price cap plan on some,[5] if not all,[6] rate-of-return carriers. The interexchange carriers ("IXCs") attempt to revive long-rejected arguments, which are no more appropriate today than they were when the Commission abandoned them years ago. The proposals fail to account for the unique challenges and cost characteristics faced by many rate-of-return carriers and ignore the size and diversity of many of the affected carriers.

I. Many Rate-Of-Return Carriers Depend On LTS To Maintain Rates At Affordable Levels.

Of the parties that comment on the Commission's tentative conclusion to merge LTS with Interstate Common Line Support, a substantial majority recognize the critical role the LTS fund has in allowing high-cost incumbent local exchange carriers ("ILECs") to maintain

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3 *See e.g.,* Comments of NRTA, OPASTCO and USTA ("NRTA *et. al.*"); Comments of National Telephone Cooperative Association ("NTCA"); Comments of Telecom Consulting Associates; Comments of ALLTEL, *et al.*; Comments of ICORE, Inc. ("ICORE").

4 *See e.g.,* ICORE Comments at 6-8; Comments of Puerto Rico Telephone Company, Inc. at 2-6 ("PRTC"); Comments of The National Exchange Carrier Association, Inc. at 11-13 ("NECA").

5 *See* Comments of AT&T Corp. at 13 ("AT&T"); Comments of WorldCom, Inc. at 2 ("WorldCom").

6 *See* Comments of Sprint Corporation at 4 ("Sprint"); Comments of The Competitive Universal Service Coalition at 5 ("CUSC").

affordable rates.[7] If the Commission's elimination of LTS as a separate support mechanism causes carriers such as Innovative to receive less explicit support than they now receive, this will significantly impact consumers' telephone rates in rural, insular and high-cost regions, which are already higher than average local rates. Innovative's comments requested that the Commission reaffirm that after the elimination of LTS as a separate support mechanism, rural and insular carriers that currently depend on LTS to maintain affordable rates "will receive Interstate Common Line Support in an amount equal to or greater than the amount of LTS support they now receive."[8] Innovate notes that no party filed comments opposing such a commitment, and again requests that the Commission reaffirm that the Interstate Common Line Support ("ICLS") mechanism will include a level of funding at least equal to the current level of LTS support so critical to many carriers.

II. Any Incentive Regulation Plan Adopted Must Recognize The Unique Characteristics Of Rate-of-Return Carriers.

The suggestions by the long-distance companies that the Commission mandate conventional price-cap regulation on rate-of-return carriers ignores the wide diversity among rate-of-return carriers. As the Commission recognized in the Further Notice, "[g]iven the wide variations among rate-of-return carrier operating conditions, . . . it would be extremely difficult to establish a mandatory alternative regulation plan for all rate-of-return carriers."[9] A mandatory price-cap scheme that aggregates over 1300 carriers with diverse challenges and cost

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7 *See* NECA Comments at 11-13; PRTC Comments at 1-6; Comments of The Western Alliance at 10-12; Comments of Verizon at 2-3.

8 *MAG Further Notice* at ¶ 274

9 *Id.* at ¶ 227.

characteristics into one or two categories would ultimately be ineffective at encouraging investment and ensuring rate-of-return carriers are able to maintain reasonable rates.

A. Optionality

AT&T urges the Commission to make price cap regulation mandatory for "larger rate-of-return LECs," which it defines as those rate-of-return carriers with "at least 50,000 lines."[10] AT&T's proposal ignores the vast diversity, other than number of lines served, that exists among rate-of-return carriers. As described in Innovative's comments, for example, carriers in insular regions face unique geographical, geological and climatological conditions that create cost characteristics unlike rate-of-return carriers serving other areas of the country.[11] As a consequence of these unique conditions, insular carriers such as Innovative often face higher costs than other rate-of-return carriers of similar size on the mainland. Mandating price cap regulation based solely on the number of lines ignores these unique cost characteristics and would not provide the flexibility necessary to allow an alternative regulatory scheme to effectively accommodate rate-of-return carriers operating in a variety of different circumstances.

AT&T's proposal is also inconsistent with prior Commission decisions in the price cap context. Price cap treatment has always been optional for all but the very largest incumbent carriers.[12] The original price cap plan provided options for even these largest carriers depending

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10 AT&T Comments at 13; *see also* WorldCom Comments at 2 (Suggesting a threshold of 200,000 lines).

11 *See* Innovative Comments at 2-4.

12 *See Policy and Rules for Dominant Carriers*, CC Docket No. 87-313, 5 FCC Rcd 6786, 6799 (1990).

on their individual circumstances.[13] There is no reason for the FCC to impose a harsher standard when developing an alternative regulatory plan for rate-of-return carriers.

B. X-Factor

The IXCs also urge the Commission to incorporate an X-factor into the mandatory incentive regulation scheme.[14] The long-distance companies base their arguments on the FCC's use of an X-factor in the price cap context,[15] ignoring key distinctions between rate-of-return and price-cap carriers that make application of an X-factor in the current context inappropriate. For example, AT&T proposes that the FCC establish an X-factor of 10 percent for rate-of-return carriers.[16] AT&T's proposed 10 percent figure lacks any supporting productivity data, ignores the 6.5 % X-factor negotiated and agreed to by AT&T in the CALLS proceeding for large price cap carriers,[17] and appears to be yet another attempt by AT&T to arrive at its desired result of an $0.0095 access rate,[18] which the Commission squarely rejected in the MAG Order.[19]

There is no indication that rate-of-return carriers could achieve the same kind of efficiency gains that larger price cap carriers have been expected to accomplish. Larger carriers have substantial economies of scale that simply do not exist for smaller, non-price cap ILECs. As the Commission found in the MAG Order, "Rate-of-return carriers … have fewer

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13 See *Access Charge Reform*, Sixth Report and Order in CC Docket No. 96-262 and 94-1, Report and Order in CC Docket No. 99-249, Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962, 12984 (2000) ("*Interstate Access Support Order*").

14 *See* AT&T Comments at 8; WorldCom Comments at 3; Sprint Comments at 3.

15 *See e.g.*, Sprint Comments at 3; AT&T Comments at 9-12.

16 *See* AT&T Comments at 10.

17 *See Interstate Access Support Order*, 15 FCC Rcd at 13018-39.

18 *See* AT&T Comments at 11.

19 *See MAG Order* at ¶¶ 86, 88.

opportunities than large price cap carriers to achieve cost saving because of their limited size, their lumpy investment patterns, and fluctuating operating expenses."[20] Moreover, each of the larger carriers can count on a steady increase in its number of lines, and can build future plans around this expansion. The Commission has recognized that smaller, rural and insular ILECs often do not have this luxury: "[R]ate-of-return carriers may not realize sufficient demand growth to realize any scale efficiencies."[21] Without solid evidence that productivity growth that outpaces that of the economy in general is possible, the imposition of a mandatory X-factor would be inappropriate.

The great diversity of rate-of-return carriers would make selection of an X-factor impossible. There is no indication in the record that any of the X-factors advocated by IXC commenters are supported by any actual data concerning the productivity of rate-of-return carriers. Selecting an X-factor even for the (then) top eight price cap carriers, which were all large companies facing similar circumstances, proved very difficult. Indeed, in order to accommodate the differences between just those carriers, the Commission initially gave these companies the choice between two X-factors, and later three.[22]

In contrast, rate-of-return carriers include approximately 1,300 companies, with a vast range in nearly every important characteristic, from size to geography of service areas to composition of their customer bases.[23] As Innovative's comments demonstrated, the only solid

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20 *MAG Order* at ¶ 86.

21 *MAG Further Notice* at ¶ 235.

22 *See Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, 6796 (1990); *Price Cap Performance Review For Local Exchange Carriers*, First Report and Order, 10 FCC Rcd 8961, 9055-56 (1995).

23 *See MAG Further Notice* at ¶ 235 (Noting that selecting a productivity offset would be difficult for rate-of-return carriers "due to the variations in their operating conditions.").

commonality between rate-of-return ILECs is that they each face unique challenges.[24] Assuming for the sake of argument that all rate-of-return carriers can be expected to have productivity gains that outstrip those of the rest of the economy, it is impossible to imagine that those gains would be the same or even similar for a medium sized carrier serving islands in the Atlantic Ocean, such as Innovative, a rural carrier serving customers in the Alaska Bush, or a carrier in the desert Southwest. In order to be certain that it was setting the correct X-factor, the Commission would have to take substantial evidence on the varying economic circumstances facing this large group of diverse carriers. As a result, any X-factor calculation that the Commission sets for the non-price cap carriers would be a massively complex exercise, requiring an enormous amount of scarce agency resources, with little chance that the final product would be an accurate reflection of reality.

AT&T and WorldCom also urge the Commission to require rate-of-return carriers subject to this X-Factor to share earnings above a certain threshold level,[25] a mechanism long ago rejected by the Commission in the price cap context as counterproductive.[26] As the Commission has repeatedly indicated, sharing severely blunts efficiency incentives by reducing the expected rewards of any efforts to reduce costs and increase efficiencies.[27] Neither AT&T nor

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[24] *See* Innovative Comments at 1-4.

[25] *See* WorldCom Comments at 3-4; AT&T Comments at 11 (citing *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, ¶ 120 (1990); *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, 10 FCC Rcd 8962, ¶¶ 210-22 (1995)).

[26] See *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Fourth Report and Order, CC Docket No. 96-262, Second Report and Order, 12 FCC Rcd 16642, 16700 (1997) ("*Price Cap Review Order*"), *aff'd in part, rev'd in part*, *USTA v. FCC*, 188 F.3d 521 (D.C. Cir. 1999).

[27] *See Price Cap Review Order*, 12 FCC Rcd at 16700; *MAG Further Notice* at ¶ 237.

WorldCom offer any evidence suggesting a sharing mechanism would avoid these adverse consequences for smaller carriers than it did for larger carriers.

C. A Low End Adjustment Mechanism Is Necessary To Adjust Rates For Rate-Of-Return Carriers That Experience Revenue Shortfalls.

Several commenters suggest that a low-end-adjustment-factor ("LEAF") should not be part of an alternative plan, or should be contingent on factors such as the existence of a sharing mechanism or the National Exchange Carrier Association ("NECA") pool's earnings dropping below a specified level.[28] Given the unique nature of the circumstances faced by smaller rural and insular carriers, a mechanism to adjust rates for revenue shortfalls is necessary to ensure that rates are compensatory, and thus Constitutional. Therefore, if the Commission does choose to reduce or eliminate the LEAF in any proposed alternative regulatory scheme, it must make sure to provide some other means to recover reasonable expenses associated with catastrophic loss.

As Innovative and a number of other commenters have repeatedly pointed out,[29] smaller rural and insular carriers face a number of unique challenges in providing telecommunications service. Because of their smaller size, these carriers cannot take advantage of the economies of scale that larger, price cap carriers enjoy. As a result, it is often more difficult for these companies to attract capital. A structure such as the LEAF, which allows carriers to rebalance their rates in the event of an unexpected shortfall, is necessary to address this problem. Indeed, just as the low end adjustment in the price cap context was intended to protect against unconstitutional takings, the LEAF is a necessary backstop feature in any alternative regulatory scheme adopted for rural and insular companies.

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[28] *See* AT&T Comments at 11-12; Sprint Comments at 3.

[29] *See* Comments of Innovative at 2-4; Comments of the Independent Telephone & Telecommunications Alliance at 6-7; Comments of GVNW Consulting, Inc. at 2-3; Comments of ALLTEL, *et al.* at 33-40; Comments of NRTA, *et al.* at 4-6.

A structure like the LEAF is particularly important to those carriers situated in areas where weather or other natural catastrophes can destroy large amounts of infrastructure quickly and unpredictably. Failure to include a LEAF, or the inclusion of a reduced LEAF, would make incentive regulation even less feasible for carriers in areas subject to frequent weather and other natural catastrophes by further exacerbating these carriers' inability to fully recover their reasonable expenses.

The FCC must address the problem of disaster recovery in any plan that it adopts. As Innovative has previously suggested, the inclusion of a LEAF structure to allow recovery up to the nominal 11.25% level in the event of a natural disaster or other calamity would be one effective method for doing so. In addition, if the Commission decides that the LEAF should be reduced or eliminated entirely, it should ensure that the plan that it eventually implements contains some method for recovery of reasonable expenses in recovering from a catastrophic destruction of infrastructure.

III. Conclusion

The Commission should continue to approach access charge reform for rate-of-return carriers cautiously by ensuring that any future modifications to the regulatory scheme do not affect the overall recovery of interstate access costs by those carriers serving high-cost areas. The Commission should therefore reject any proposals for alternative regulatory schemes that fail to account for the unique challenges and cost characteristics faced by many rate-of-return carriers and ignore the size and diversity of many of the affected carriers.

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